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CONTENTS

ARTICLES

- A Contribution to the Understanding of Right 1
DENNIS T. MANDUDZO
- The Concept of Separation of Powers in Zimbabwe: Constitutional Myth or Reality? 10
WELSHMAN NCUBE
- Access to Water: Right or Privilege? 26
JENNIFER MOHAMED-KATERERE
- Compulsory Acquisition of Land in Zimbabwe 50
BEN HLATSHWAYO
- Legal History in Law: A Zimbabwean Perspective 65
WELSHMAN NCUBE
- Equality as Justice or Justice as Fairness? Kantianism and Socio-Economic Rights 78
DENNIS T. MANDUDZO
- Insolvency and the Corporate Debtor: Some Legal Aspects of Creditors' Rights Under Corporate Insolvency in Zimbabwe 85
LOVEMORE MADHUKU
- The Exclusive Economic Zone: A Look at International Law Uses for Other States 93
WEBSTER N. CHINAMORA
- Voodoo Law Brewed in the African Pot?: Judicial Reconstruction of the Customary Law of Inheritance in Zimbabwe 101
WELSHMAN NCUBE
- The Right to Strike in Zimbabwe 113
LOVEMORE MADHUKU
- Sentencing First Offenders in Botswana 125
KHOLISANI SOLO

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Redstar X., "An Exegesis on the Ideology of Ideologies in Law" 1994 *Zimbabwe Law Review* Vol. 11.

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INSOLVENCY AND THE CORPORATE DEBTOR: SOME LEGAL ASPECTS OF CREDITORS' RIGHTS UNDER CORPORATE INSOLVENCY IN ZIMBABWE

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INTRODUCTION

A debtor who is unable to pay his debts triggers the pursuit of a variety of remedies by his creditors. However, the law has, since historic times, refused to give creditors an unbridled avenue to the debtors' person or assets in satisfaction of their claims. An important issue in every legal system is the determination of whether a creditor's rights are adequately protected *vis-a-vis* a debtor who is unable to pay his debts. Almost always, the issue resolves itself into an examination of the insolvency laws of the legal system. This is so because a creditor, notwithstanding having obtained judgement against the debtor, finds himself in competition with others over the debtor's meagre assets. Thus an insolvency proceeding provides an easy way out as it replaces "the free-for-all" attendant upon the pursuit of individual claims by different creditors with a statutory regime in which creditors' rights and remedies are suspended, wholly or in part, and a mechanism is provided for the orderly collection and realisation of assets and the rateable distribution of dividends among creditors' claims. In Zimbabwe, the Insolvency Act (Chapter 303) provides and regulates a system under which an individual debtor (as distinct from a corporate debtor but including a partnership) who is unable to pay his debts hands over his property to a trustee for sale and distribution among his creditors. The creditors soon discover, however, that on the grounds of public policy, the law does not make all assets of the debtor available for distribution among creditors.¹ Thus clearly, insolvency law is not merely a question of settling creditors claims — it is a matter of striking a balance among the interests of the debtor, the creditors and society. For instance, society continues to insist that a debtor who is unable to pay his debts should nevertheless give preference to his dependants over his creditors.²

The corporate debtor who is unable to pay his debts is governed not by the Insolvency Act (cap. 303) but by provisions in the Companies' Act (cap 190). To what extent are creditors' rights protected? Is the insolvency regime enshrined therein sensitive to the broader objectives of insolvency law that is moving away from an exclusive orientation towards creditors' interests to encompassing (in addition to creditors) interests of the corporate debtor and society? This article seeks to explore these questions.

It must be pointed out, *ex abundant cautella*, that the view of this article is that the present corporate insolvency law is too wary of the interests of creditors to the extent of sacrificing one of the other legitimate objectives of this branch of the law — the societal interest in the facilitation of the recovery of companies in financial difficulty.³ It is common cause that the continued survival of a company has crucial societal benefits. For instance, the company's employees do not lose jobs — a consequence which has serious attendant economic and social problems.

1 Goode, R. M. *Principles of Corporate Insolvency Law*, Sweet & Maxwell (London), 1990, page 2.

2 See Insolvency Act (Cap 303), sections 25, 37 98.

3 See *Philip & Co (Pvt) Ltd v Adie* 1970 (1) RLR 237, 1970 (4) SA 251.

This article in exploring the questions posed above, seeks to survey the corporate insolvency regime in Zimbabwe with a view to showing that, more clearly than not, it is so creditor-oriented that it serves no other purpose. It will be shown that such a state of affairs is undesirable.

THE CONCEPT OF CORPORATE INSOLVENCY

Insolvency exists when a debtor is unable to pay his debts.⁴ Some have taken the concept in a narrower manner to refer to a state of affairs where liabilities of a debtor exceed his assets. Ian Fletcher crisply represents this conception as follows:

The essence of the concept of insolvency consists in a debtor's ultimate inability to meet his financial commitments: "upon a balance of liabilities and assets, the former exceed the latter with the consequence that it is impossible for any of the liabilities to be discharged in full at the time of falling due".⁵

Be that as it may, insolvency exists at the very least when a debtor is unable to pay his debts, whether or not the liabilities exceed the assets. Corporate insolvency is thus a self explanatory concept. It arises when a company is unable to pay its debts.⁶

It must be noted that a state of insolvency does not, in itself, have any legal consequences. A company which is unable to pay its debts can continue its business without committing a civil wrong or a crime. The state of insolvency becomes relevant when formal insolvency proceedings have been instituted. So far as creditors are concerned, a state of insolvency (i.e. inability to pay debts) is a *sine qua non* for

- (a) instituting a winding up⁷ and
- (b) seeking a judicial management order.⁸

It is within this context that insolvency gets linked to the protection of creditors' interests *vis-a-vis* a corporate debtor. Thus a creditor faced with a corporate debtor unable to pay its debts and wishing to settle his claims out of the company's assets has a right to institute proceedings for either winding up or judicial management of the company. It is the exercise of this right by creditors which shows the overwhelming generosity granted by our corporate insolvency law to creditors at the expense of other legitimate interests.⁹

WINDING UP AND CREDITORS' RIGHTS

Winding up (commonly referred to as liquidation) is a process which brings to an end a company's existence. As such, it is a drastic remedy and one would have expected the law to restrict the extent to which creditors may bring about the winding up of a company. On the contrary, where a company is insolvent, creditors have easy access to the machinery of

4 Smith C, *The Law of Insolvency*, 3rd edition, Butterworths, Durban, 1988 page 1.

5 Fletcher I. F., *The Law of Insolvency*, Sweet & Maxwell (London), 1990 page 1.

6 See generally Goode, R. M. (op. cit) note 1.

7 See section 172 of the Act.

8 See section 271 of the Act.

9 It is now recognised that corporate insolvency law should not just be concerned solely with the orderly assembly and distribution of assets among creditors, but also with other interests like ensuring that company employees remain, as far as possible, in employment. In England, the most instructive literature on the wide objective of corporate insolvency law is the Report of the Insolvency Law Review Committee, *Insolvency Law and Practice*, Cmnd, 8558 (1982).

winding up, thus protecting their interests more than that of any other group of persons who suffer from the demise of a company.

Winding up is governed by the Companies Act (Cap 190) (hereinafter called 'The Act'). There are two forms of winding up, namely winding up by the court and voluntary winding up.¹⁰ The Act lays down seven grounds on which a company may be wound up by the court. Section 179 provides:

179 A company may be wound up by the court:

- (a) if the company has by special resolution resolved that the company be wound up by the court.
- (b) if default is made in lodging the statutory report or in holding the statutory meeting.
- (c) if the company does not commence its business within a year from its incorporation or suspends its business for a whole year.
- (d) if the number of members is reduced below two.
- (e) if seventy-five per centum of the paid-up share capital of the company has been lost or has become useless for the business of the company.
- (f) if the company is unable to pay its debts
- (g) if the court is of the opinion that it is just and equitable that the company should be wound up.

Inability to pay debts (insolvency) is made one of the grounds for winding up and in practice it is the ground mostly relied upon by creditors seeking a winding up order.¹¹ The way the courts have interpreted this ground, as will be shown, succinctly confirms the view adopted by this article, that in the event of insolvency of a company, it is the creditors who call the tune. The overwhelming protection of the creditors in the event of insolvency will now be examined. At the outset, it should be observed that the conception of the law in this context is that, in the machinery of winding up, the creditor has a remedy to the settlement of his claims, and thus it is essential to give him ready access to the machinery.

Firstly, the Act amplifies the ground of inability to pay debts by creating three circumstances in which a company is deemed to be unable to pay its debts.¹² Briefly stated, the three circumstances are:

- (a) where the company fails to pay a creditor for three weeks after formal demand,
- (b) where a sheriff or messenger of court has given a *nulla bona* return on a unit of exemption, and
- (c) where there is proof that the company is unable to meet its present, contingent and prospective liabilities.

The deeming provisions clearly make it very easy for a creditor to satisfy the requirement of S179(f) particularly in the cases of circumstances (a) and (b). For instance, in (a), it is not necessary for a creditor to have obtained judgement in respect of the debt upon which his demand is based. Although it was held in *Mann v Gold-stein*¹³ that the words "neglected to pay" should be understood to mean "omitted to pay without reasonable excuse", case law makes it clear that the company's excuse has to be *bona fide* and substantial. Thus in *Re Tweeds Garages Ltd*¹⁴ and *Re Welsh Brick Industries Ltd*¹⁵ it was held that a mere dispute as to

10 Section 172 of the Act.

11 See for instance the observation — Christie R. H., *Business Law in Zimbabwe*, Jute & Co, page 432.

12 Section 178 of the Act.

13 [1968] 1 W.L.R. 1091.

14 [1962] ch. 406.

15 [1946] 2 AUER 197 (CA).

the precise amount of the debt or the simple fact that the company has been given unconditional leave to defend an action relating to the debt, does not bar a creditor from proceeding in terms of this deeming section. This makes the creditor proceeding therein almost untouchable. The courts have actually made it clear that the creditor's *mala fides* does not arise, as long as he falls within the ambit of the section. As Thomas J. put it:

I come now to the allegation of *bona fides* and to abuse of process. It seems to me that to pursue a substantial claim in accordance with the procedure provided and in the normal manner, though with personal hostility or even venom and from some ulterior motive, such as the hope of compromise or some indirect advantage, is not an abuse of the process of the court or acting *mala fide* but acting *bona fide* in accordance with the process.¹⁶

He went on to add:

When the creditors' debt is clearly established it seems to me to follow that this court would not, in general at any rate, interfere even though the company would appear solvent, for the creditor would, as such, be entitled to present a petition and the debtor would have its own remedy in paying the undisputed debt which it should pay.

The position seems to be premised on protecting the creditor's interests at any rate and arguing that the company has a remedy in paying the undisputed debt. This is tantamount to sentencing a person to death merely on the failure to pay a debt falling due. The reasons for failing to pay are irrelevant. A company which is undergoing a temporary cash flow problem, and decides to meet running costs like rent and wages in preference to a creditor, though solvent, may be wound up under this deeming provision. This is illogical as the deeming provision is intended to assist creditors in proving insolvency and this position which may make solvent companies liable to winding up on mere failure to pay a debt falling due cannot be defended on any basis. It is a superfluous protection of creditors which has to be reconsidered. The same criticism applies to (b).

In (c), a catch-all phrase is utilised to allow the court to accept any mode of proof which establishes that a company is unable to pay its debts. The creditor-oriented nature of the provision comes with allowing contingent and prospective liabilities to be taken into account. A contingent liability is a liability arising from an existing legal obligation but dependant on the happening of an event which may or may not occur (*Re William Hoddy Ltd*).¹⁷ A simple example of a contingent liability is that of a surety which depends on default by the principal debtor. A prospective liability is less clear, but it has been defined as a present debt which has not yet been finally established or quantified.¹⁸ A liability to pay for work in progress is an example of a prospective liability.

Taking into account contingent and prospective liabilities renders a company susceptible to the machinations of a creditor intent on a winding up. Contingent and prospective liabilities unnecessarily and unrealistically increase the company's liabilities over the assets easily making it look insolvent. Although it has been said that the court must not regard contingent liabilities as if they were due and payable (*Barclays Bank (DC&O) Ltd and Another v Riverside Dried Fruit Co (Pty) Ltd*)¹⁹ the effect of taking them into account for purposes of proving inability to pay debts is to treat them as though they were due and payable. There

¹⁶ *Mann v Goldsteir* (*supra*) note 13, page 1094.

¹⁷ [1962] 2 AUER 11.

¹⁸ *Re a Debtor* (No. 17 of 1966) [1967] 1 AUER 668 at page 670.

¹⁹ 1949 (1) SA 937 (C).

is no doubt that this state of affairs in the law is essentially a scheme to assist creditors who seek winding up as a remedy for their claims against the company.

Secondly, the concept of inability to pay debts, even outside the deemed circumstances of insolvency, has not necessarily been understood to mean a *de facto* as distinct from a *de jure*, state of insolvency. Thus even where a company's assets ultimately exceed its liabilities, but it is unable to pay its debts as they fall due, it will be held to be insolvent.

This position which has been technically referred to as "commercial insolvency" was clearly put on a firm footing in *Rosenback & Co. (Pty) Ltd v Singh's Bazaars (Pty) Ltd*.²⁰ As Caney J emphatically put it:

The proper approach in deciding the question whether a company should be wound up on this ground appears to me, in the light of what I have said, to be that, if it is established that a company is unable to pay its debts, in the sense of being unable to meet its business, it is in a state of commercial insolvency.²¹

The judge made no secret that this is done for purposes of protecting creditors. He added:

... the court will have regard to the fact that 'a creditor who cannot obtain payment of his debt is entitled as between himself and the company *ex debitis justifier* to an order if he brings his case within the Act. He is not bound to give time' ... This view is supported also by Palmer at 27: "The fact that there is due to the petitioner a liquidated sum, that the debt is not disputed, and that the petitioner has demanded payment without success, affords cogent *prima facie* evidence of the company's inability to pay its debts, and is the evidence most commonly relied on". This appears to me to accord with sound business principles, for a concern which is not in financial difficulties ought to be able to pay its way from current revenue or readily available resources.

Thirdly, once the liquidation process gets underway, it is a paramount duty of the liquidator to ensure that the company's assets are collected and distributed among the creditors (*CSAR v Geldentinus Main Reef GM Co Ltd, in Liquidation*).²² No other consideration is permissible. In particular, the liquidator cannot carry on business for the purposes of making a profit for the company or for the benefit of shareholders or company's employees. It is only that business which increases the creditors' benefits which is permissible.²³ The creditors are entitled to give directions to the liquidator.²⁴

There is no philosophical justification for prohibiting a liquidator from carrying on business, during the course of the liquidation, which benefits the company by way of reaping profits. If it were realised that it is desirable that insolvency law should go beyond the interests of creditors to the protection of the societal interests such as facilitating the recovery of a company in financial difficulty, this prohibition on a liquidator's scope of duties would easily be jettisoned.

Fourthly, the court has a discretion, notwithstanding proof of a company's insolvency, to make or refuse a winding up order.²⁵ This discretion has not been used against creditors nor has it been used to ensure that the company is not put to an end by a *mala fide* creditor.

20 1962 (4) SA 593 (D).

21 *Ibid* at page 595.

22 908 TH 11.

23 See *In Re Wreck Recovery and Salvage Co* 1880 CLD 343, *Rigby v Union Fruit & Circus Fruits Ltd* (in liquidation) 1931 TPD 265 *Export Provisional Liquidator of Bulawayo Hotels* (1958) (Pvt) Ltd 1959 (1) R & N 561.

24 Section 195 of the Act.

25 Section 181 of the Act.

The circumstances in which the discretion has been used to refuse an order are usually those on which the petitioner is not a creditor. For instance in *Taylor v Machane Calims Syndicate*,²⁶ the court refused to make a winding up order on the ground that the company had pursued, with the approval of the shareholders, a policy of inactivity for more than a year. It could not grant the order to the applicant, a shareholder, who desired a policy of activity. In *Martin v van Ordt, Russel & Co(Pty)*,²⁷ an applicant who was a party to a moratorium agreement had a winding up order refused. Where a creditor is involved, the discretion will be refused, it would appear, where the interests of other creditors would be prejudiced. This happened in *F&C Building Construction V Machseil Investment*.²⁸ In the case, on the return day of a *rule nisi* calling upon the company and "other interested persons" to show cause why the company should not be wound up, a creditor of the company appeared to oppose the confirmation of the rule. The petitioning creditor was owed \$4 276 while the opposing creditor was owed about \$24 000. The latter's argument was that a winding up order would not be in the interests of creditors generally. The winding up order was thus refused. Fannin J summarised his very clear creditor oriented exposition as follows:

Total, the creditor which opposes a winding-up order, is a secured creditor for some \$15 846, and an unsecured creditor for some \$7 786. The petitioner is an unsecured creditor for some \$4 726, and being unable to recover its debt, claims to be entitled to have the respondent company wound up. The petitioner is entitled to such an order, despite the fact that the secured creditor will consume all the assets, as the probabilities indicate, unless it can be shown that there is no reasonable possibility that unsecured creditors will derive any benefit from the winding up, and the onus is on the creditor to show that. I find that onus has been discharged . . .²⁹

Thus, while in theory the discretion of the court could be used for any legitimate purpose contemplated by the court, in practice the courts have retained a very conservative approach which only seeks to advance creditors' interests. This, of course, reflects the dominant view of the courts as regards the proper function of corporate insolvency law, namely to provide an orderly realisation of a corporate debtors' assets for the benefit of the creditors. The winding up insolvency proceeding amply demonstrates this conception.

JUDICIAL MANAGEMENT AND CREDITORS' INTERESTS

Professor Hahlo, says of judicial management:

Judicial management is a half-way house between the life and death of a company. When by reason of mismanagement or for any other cause a company is unable or probably unable to meet its obligations but has not become or prevented from becoming a successful concern and there is a reasonable probability that if it is placed under judicial management it will recover and become a successful concern, the court may, if it appears just and equitable, grant a judicial management order.³⁰

As the above observation makes clear, judicial management, unlike winding up, is aimed at facilitating the recovery of a company which is in financial difficulties. It is governed by section 271 of the Act. The section makes it clear that this order may be made even where the company is insolvent i.e. unable to pay its debts, and hence its importance. It is submitted

26 1912 WLD 196.

27 1939 CPD 106.

28 1959 (3) SA 841 (D).

29 At page 843.

30 Hahlo H. R., *South Africa Company Law Through the Cases* 3rd edition, Juta & Co, 1977 p 714.

that judicial management is, in principle, an insolvency proceeding which gravitates away from the predominantly creditor orientation of winding up to the interests of the company. To this extent, it is a desirable form of insolvency.

However, the dominant view of the purpose of corporate insolvency being the mere assembly of the debtor's assets for distribution among creditors is still apparent in the restriction of the scope of operation of judicial management. There are, however, some clear indications that this corporate insolvency regime is moving away from the sole protection of creditor's rights to the protection of the survival of the company. Needless to say, an emphasis on the survival of the company ultimately serves the interests of the creditors, shareholders and company's employees thus promoting a balanced socio-economic environment for society. Aspects of the law on judicial management which are commendable are as follows:

First, the courts have been very emphatic in articulating a clear purpose for this insolvency proceeding. For instance, in *Lief No v Western Credit (Africa) (Pty) Ltd*,³¹ Snyman J said:

A winding up order, in its nature, is intended to bring about the dissolution of the company, whereas the purpose of a judicial management order is to save the company from dissolution.

And in *Looks' Estate v Graaff-Reinet Board of Executors*,³² the court held that:

Judicial management is a means of resuscitating a company which has got into serious difficulties, either through a lack of funds or through mismanagement by placing the management in the hands of a competent person.

Second, in *Kotze v Tullbyk Ltd and Others*³³ and in *Tobacco Auctions Ltd v A W Hamilton (Pot) Ltd*³⁴ it was held that what is required for a court to grant a judicial management order is simply "a reasonable probability" and not a *strong probability*, that by proper management the company may surmount its difficulties. This was a disapproval of the unnecessarily high standard which had been set in *Silverman v Doornhoek Minies, Ltd*³⁵ where De Wet J had stated:

... the object of the section is to obviate a company being placed in liquidation where there is some *strong probability* that by proper management or by proper conservation of its resources it may be able to surmount its difficulties and carry on. It is a special privilege given in favour of a company and is to be authorised only in very special circumstances.

Third, judicial management is competent even with a private company whose membership is very small or whose issued share capital is small.³⁶

Fourth, the court has the power to supervise the judicial manager who, unlike the liquidator, does not receive directions from the creditors.³⁷

It is clear therefore that judicial management, while it ultimately protects creditors' interests by ensuring that the company continues to survive and thus service its debts, is wider in

31 1966 (3) Sa 344 (W).

32 1935 CPD 115 at 19.

33 1977 (3) SA 118.

34 1966 RLR 190, 1966 (2) SA 451.

35 1935 TPD 349 at 353.

36 *Tobacco Auctions Ltd v A (supra)*.

37 See sections 172 and 274 of the Act.

its scope in protecting the interests of the shareholders and the company's employees. It is therefore a more desirable form of corporate insolvency proceeding whose scope of operation must be widened.

There are aspects of the law on judicial management which continue to reflect a creditor orientation with winding-up. Under a conservative judiciary bent on protecting creditors only, such aspects may take the steam out of an otherwise progressive insolvency regime.

First, as clearly explained in *Ex parte MayLew*³⁸ and in *Ex parte Porter and Another: In re Clemeo Timbers (Pvt) Ltd*³⁹ the company cannot by itself apply for a judicial management order.⁴⁰ It is only the creditors or members of the company who may apply. This position is illogical. After all it is the company which is better able to tell whether or not a change of management will take it out of financial difficulties particularly when it is noted that the consequences of winding up are drastic and undesirable for society generally.

Second, *Silverman (supra)* has not been overruled. It is still technically possible for a court to follow the requirement of a "strong probability". However, this is unlikely as the section itself uses the expression "reasonable probability".

Third, *Ex parte MayLew (supra)* emphasised that since section 271 (1) requires a reasonable probability to be established, a lack of opposition to the granting of the order does not entitle the court to dispense with the requirement. In principle, this may be right, but it is unrealistic as the court, in the absence of contrary evidence, may have no basis for asserting that there is no reasonable probability of recovery. It is thus suggested that lack of opposition should be *prima facie* evidence of the reasonable probability required by the section.

Fourth, the courts seem to be very conscious of the wide discretion in deciding whether or not to issue a judicial management order. The discretion has not been judicially defined and it could be used to stifle the progressive nature of judicial management. For instance, in *Tobacco Auctions Ltd v Hamilton (Pvt) Ltd*,⁴¹ a lone judicial voice has warned that the courts will be reluctant to grant a judicial management order where shareholders wish to benefit by keeping creditors waiting a long time for payment.

By and large however, judicial management protects all interests involved, namely those of creditors, shareholders and company's employees and is to be preferred to a winding up.

CONCLUSION

It has been shown that corporate insolvency law in Zimbabwe largely aims at the exclusive protection of creditors' interests at the expense of other legitimate interests like those of shareholders and more importantly, those of the company's employees. This aspect of the law is clearly contained in the winding up procedure contained in the Company's Act (Cap 90). However, it has been conceded that the other insolvency proceeding of judicial management, is a progressive insolvency mechanism whose superiority lies in its attempt to protect the interests not only of creditors, but also of shareholders and the company's employees. Its scope of operation is, however, limited, leaving our corporate insolvency law largely creditor-orientated.

38 1959 (i) R & N 133.

39 1960 R & N 269.

40 See *Clarke v Protein Foods (Pvt) Ltd* 1970 (2) RLR 278.

41 1966 RLR 190.



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